CHILE: Domestic risk

With Chile in good shape despite the international crisis, President Sebastián Piñera must now decide how to respond to popular calls for more spending in social programs and deal with his administration's seriously low disapproval rate.

Solange Monteiro, Santiago, Chile

"IN 20 DAYS I THINK we have moved more than others in 20 years," recently elected President Sebastian Piñera said about the speed of his administration's action to repair the earthquake damage followed by tsunami that Chile suffered in February 2010. For the first time since Chile became a democracy, it had elected a center-right candidate. The 51.6% votes that put Piñera in office were betting that, given the stable economy, an entrepreneur's pragmatism would accelerate changes to improve their quality of life. "The president's message was to maintain the same policy stance but advance in a more efficient way," says Patricio Navia, professor, the Center of Latin American Studies at New York University and the Research Institute of Social Sciences of Diego Portales University.

In the year and a half that the administration has been in control, the scenario has become more complex. Chile is highly dependent on copper exports and the economic strength of trading partners, but this year the Piñera administration should do relatively well despite the international crisis, thanks to policies carried out by the national unity government during the previous 20 years that built up a comfortable buffer of international reserves. "Even the Organisation for Economic Cooperation



Photo: Antonio Cruz/ABr.

Presidente Piñera has a tough job ahead to respond to calls for more social programs.

and Development [OECD] recognized Chile as one of the countries best prepared to face this crisis," says Finance Minister Felipe Larraín.

But now, on the domestic front, President Piñera needs to respond to a demand that had been pent up for 20 years: more spending on education and health and reform of the pension system. The most evident sign of dissatisfaction was that in 2011 students took to the streets for seven months and helped sink the government's approval rate to 22%. The risk of a repeat this year cannot be ignored. This may become Piñera's main challenge.

Conservative stamp

The Chilean economy is expected to grow 4% in 2012, compared to 6% in 2011, now that, among other factors, some industries affected by the earthquake are back in full operation. To César Peréz, executive director of studies, Celfin Capital brokerage, this growth, though lower, would demonstrate good performance, "especially if we take into account the slowdown of Chile's main trading partners" (China, the United States, Japan, and Europe).

The drop in demand for copper and therefore its price are not minor factors for Chile, the world's leading producer. According to the Chilean Copper Commission (COCHILCO), copper exports accounted for 20% of GDP in 2010. "The price of copper reached US$4 per pound in 2011 compared to US$1 in 1990," Peréz points out. Meanwhile, says Jorge Bunster, director-general, Chile's Direction of Foreign Trade (DIRECON), efforts to diversify exports and markets have been constant.

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"Today, products like forest products and fresh fruit have grown significantly," he says. "We have 21 trade agreements with 58 countries. Last year, we negotiated with Turkey, Malaysia, Vietnam and Nicaragua, and now we have begun talks with Thailand and Hong Kong."

Even with the range of trade agreements, though, the prediction that the trade balance will plunge is unanimous. For one thing, according to Celfin Capital, the price of copper is likely to fall to US$3.60; for another, there is likely to be a high demand for oil imports from the energy sector, which is heavily oil-dependent. Peréz says, "We believe that the trade surplus, which was US$12 billion in 2011, will fall to US$5 billion."

But such bleak prospects do not shake Minister Larraín's confidence. He says, "Every cent less in the price of copper represents a decrease of US$60 million in tax revenues; however, our budgetary policy is based on the long-term price of copper of US$3.02. We do not depend on the current valuation of copper to pay our bills." Chile's current economic strength was firmly established after a series of reforms to reduce the vulnerability caused by its heavy dependence on one commodity. In

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>
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2001, these reforms culminated in adoption of the concept of structural budget balance. This insulates the public budget from cyclical economic conditions because expenditures are based on potential GDP and the tax revenue trend. Revenue surpluses are saved, preparing the ground for countercyclical policies in years when cows are lean.

Furthermore, a sound structural budget has also reduced the volatility of interest rates and made Chile's debt more credible. Larrain points out that "Last September, in the midst of uncertainty in international markets, in the United States we issued US$1.35 billion in 10-year bonds at a rate of 3.35%—the lowest in history for a Latin American country."



Photo: Osmar Valdebenito/Wikimedia Commons.

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The adoption of the structural budget balance made it possible to create a reserve fund for low-income pensions in 2006 and a debt stabilization fund in 2007. "Chile's international reserves are nearly US$40 billion, and the debt stabilization fund and the pension reserve fund add another US$32 billion. These are important buffers," says Peréz.

Social demands

Though healthy public finances and high national savings (24% of GDP) make for relative economic tranquility, the Piñera administration still has social challenges to deal with. "The problem is the low supply of public goods," says economist Hernán Frigolett, partner, Aserta Consultants. The demands for action are not new but they have intensified recently. The 2010 World Economic Forum ranked Chile 30th (of 139 countries) in competitiveness and 40th in infrastructure, but the country sank to 101st in education and 123rd in the quality of science and mathematics teaching. "In public universities, average monthly tuition is US$500, yet a family's average monthly income is only US$1,500," Frigolett says. Usually families borrow to pay tuition fees, and "with interest of 7% a year plus inflation, education loans are more expensive than mortgage loans." Frigolett added, "The OECD January 2010 report points out that the poor quality of education is one of the factors that explain Chile's persistent low productivity and high income inequality."

Minister Secretary-General of Government Andrés Chadwik Piñera explains that "the 2012 budget almost doubles the number of scholarships," and "education loans with government guarantee were modified to reduce the interest rate to 2% a year, and include contingencies for periods of unemployment."

These measures will cost the government US$1.3 billion. Whether they will be effective will become apparent only in March, when students return to school—or to the streets. The student unrest is making visible the demand for improvements in the quality of public services generally, Frigolett thinks, adding, "The public health system is deficient and in need of modernization; our pensions system also excludes many people, such as informal workers."

Models for growth

The government and the opposition have begun a heated debate over tax reform to increase revenues and investment. While the government wants simply to make the tax system more efficient, the opposition argues that the tax base needs to be broadened and direct taxes—currently 18.5% of GDP—should go up.

Income tax evasion is a major problem. The OECD estimates that tax evasion costs Chile about 3% of GDP. Senator Ricardo Lagos Weber, Party for Democracy, which led the opposition in the tax debate, advocates a gradual income tax increase of 3 or 4 percentage points of GDP, though he recognizes that it is also important to curb exemptions. "With these measures," he says, "we will treat labor income the same as capital income, and we will be able to reduce direct taxes, which currently account for 60% of total tax collections."

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Finance Minister Larraín points out, however, that "the external situation is fragile, and we must have patience. We cannot have free education now. Likewise, we have to focus on tax improvements that encourage growth, investment, and good environmental practices." Chadwik Piñera says, "Around the world, the opposition asks for more than governments can offer, but we are very clear how far we can go. We grew 6% in 2011, we created more jobs than ever, and we know how to do it."

Ricardo Ffrench-Davis, former central bank chief economist now professor of economics, University of Chile, thinks that the changes the country needs go further. To reduce income inequality will only be possible with a change in the focus of macroeconomic policy—and the policy agenda—he believes. "Since the return to democracy, we have had an ambitious agenda of social reforms, which unfortunately was not directly coordinated with economic policy." The result, he says, has been a gradual decrease in Chile's growth.

These issues are likely to be factors in the 2013 presidential elections. At that point, however, both government and opposition will have to cope with a new element: changes in the electoral system, including adoption of voluntary voting, may create an unusual degree of uncertainty. That is one more reason why the administration must work to change its approval rating.